

ME-0137

HOUSING FINANCE PROGRAM

EXECUTIVE SUMMARY

Borrower:	<i>Banco de Servicios y Obras Públicas (BANOBRAS)</i>		
Guarantor:	United States of Mexico		
Executing agency:	<i>Fondo de Operación y Financiamiento Bancario a la Vivienda (FOVI)</i>		
Amount and Source:	IDB (OC):	US\$ million	505
	<u>Local:</u>	<u>US\$ million</u>	<u>665</u>
	Total:	US\$ million	1,170
Financial terms and conditions:	Amortization Period:		25 years
	Disbursement Period:		3 years
	Interest Rate:		Variable
	Supervision and Inspection:		1.00%
	Credit Fee:		0.75%
	Currency:	Single Currency Facility US\$	
Objectives:	<p>The overall objective of the Program is to improve the efficiency of Mexico's formal housing finance system and facilitate its expansion to lower income segments of the population. Specifically, the proposed Program aims to consolidate the reform of a successful second-tier mortgage finance institution, FOVI, and to finance eligible housing subsidies and mortgages under the Program's operating regulations for the next two years – the period of time needed for the new government to articulate and implement an overall housing sector strategy, including a sustainable funding strategy for FOVI.</p> <p>FOVI's reform rests on two pillars: on one hand, an overhaul of FOVI's products aimed at: (a) turning the existing interest rate subsidy into an upfront subsidy to be complemented with market rate mortgage credit; (b) making the upfront subsidy portable for the borrower, i.e. independent from the house to be acquired; and (c) separating mortgage financing from construction financing, and scaling down the latter. The new upfront subsidy will: (a) improve efficiency and reduce cost to the Government; (b) improve targeting by restricting eligibility to below-median urban income households; and (c) encourage own-resource mobilization. (See paragraphs 1.13 and 1.14.)</p> <p>The second pillar of the reform will be the design and implementation of a sustainable funding strategy for FOVI programs. Eventually, the subsidy program will have to be funded with fiscal resources while the credit program will have to rely on private funding sources. (See paragraph 1.22 and following).</p>		
Description:	To reach its objectives, the Program will finance two components:		
	A. Investment component (US\$495 million). This component will		

provide resources to co-finance both the credit and subsidy programs of FOVI for the 2001-2002 period. IDB resources will be passed to FOVI in Mexican currency through BANOBRAS in the form of a loan. The rate applicable on the loan to FOVI will be set, for every disbursement, so as to pass to FOVI the spread between the IDB lending rate and the Government of Mexico foreign bond issues (currently at 150 basis points). Proceeds from the loan will be used by FOVI to generate a combination of market rate mortgages and up-front subsidies, without decapitalizing FOVI. The IDB-funded mortgages will be completed by funds raised on the capital market; while the IDB-financed up-front subsidies will be complemented through budgetary appropriations and other similar resources. Over the life of the Program, the IDB contribution will go down as the market contribution (for credit) and the Government contribution (for subsidies) ramp up.

- B. **Technical assistance (US\$10 million).** This component aims at preparing FOVI for the challenges ahead (managing the up-front subsidy program and accessing the financial markets). To this end, it will finance technical assistance to: (1) finalize the design and monitor the implementation of the reform of FOVI's products; (2) design and implement a sustainable funding strategy for FOVI's programs; (3) help improve the housing policy framework affecting FOVI's operations; (4) strengthen the primary market infrastructure; (5) facilitate the development of the secondary market; (6) improve FOVI's operating environment; and (7) assess the impact of FOVI's programs on market development.

**Relationship of
Project in Bank's
country and
sector strategy:**

The next five years will be critical for Mexico's housing finance system. The prospect for increased private funding is still uncertain as commercial banks prepare to return to the market. Public funding will remain scarce since budgetary restrictions will persist in the foreseeable future. Given the social implications of FOVI's activities, the Government of Mexico has requested the support of the Bank to help fund FOVI's subsidy program during the transition to market rates. At the same time, the operation is consistent with the Bank strategic line of action to promote private sector development in Mexico, since Program resources will leverage private resources and facilitate the connection between the housing finance system and the capital markets.

The proposed Project has been prepared primarily with the outgoing administration. However, the incoming administration has been involved at the pre-negotiation stage and its participation in loan contract negotiations will be sought. The incoming administration recognizes the key role played by FOVI in the housing finance system and agrees that the reforms proposed under the Program are necessary. Additionally, the Program has been designed to allow for flexibility in the execution phase so as to take into account the specifics of the incoming administration's housing policy once they are finalized.

**Environmental and
social review:**

The Program's Environmental and Social Brief was sent to the PIC on September 23, 1999. No environmental impact assessment was required by the Committee on the Environment and Social Impacts (CESI). The Program will have limited but positive impacts on the environment, since it will help FOVI enhance its environmental review procedures (see paragraph 4.12). The main social issue involved has to do with the

distributive impact of the new subsidy policy. Improved targeting is a central objective of the new policy (see paragraph 4.7). Another important social issue has to do with the gender implications of housing lending. The Program will develop a set of activities aimed at ensuring that FOVI's programs provide equal opportunity to women and men (see paragraph 4.14 and following).

Benefits:

The *investment component* will finance the up-front subsidy needed to bring about 60,000 households earning less than the median urban income to the formal mortgage market. Beyond this specific contribution, the introduction of the new subsidy scheme will have a variety of positive impacts: it will increase the efficiency of Government spending and household spending; it will improve the targeting and transparency of the allocation process; and it will help leverage savings and lower credit risk for lower income beneficiaries. (See paragraph 4.2 and following.)

Technical assistance and reform of FOVI. The separation of the responsibility for financing subsidies (eventually from budget allocations) from the responsibility for financing credit (eventually with market resources) will have important benefits in terms of transparency, efficiency and sustainability. (See paragraph 4.9.)

Another positive impact expected from FOVI's reform will be the decrease in the all-in cost of credit for FOVI borrowers (measured against the Government's cost of funding), through enhanced creditworthiness for FOVI, increased competition between intermediaries, better origination and servicing standards, and a more efficient management of risks, eventually through private insurance schemes. A significant reduction in the all-in cost of credit may be expected. (See paragraph 4.10.)

Risks:

The main risk involved with the proposed Program has to do with the *sustainability of the financing for the upfront subsidy*, notably given the current budgetary restrictions facing the Mexican Government. The sustainability risk is unavoidable in a system where subsidy financing is part of the budgetary process and therefore subject to congressional approval. In the medium term, the policy of the next government will be critical to ensure that the subsidy program lasts and expands. In the longer run, the relatively low annual level of subsidy agreed upon in designing the proposed Program (US\$140 million, i.e. less than 0.2% of total government budget) should make it relatively easy for FOVI to secure funding. In any case, because it fosters the replacement of the rate subsidy with an upfront subsidy, the Program has the benefit of making the sustainability risk more explicit. (See paragraph 4.18 and following.)

Another risk has to do with the *financial position of FOVI* itself, which is weakened by the rate mismatch between assets and liabilities in its existing portfolio. In the future, the subsidies embedded in old mortgages could become an unfunded liability for FOVI. An important step to isolate this risk and eventually mitigate it will be to clearly separate the old portfolio from the new one. The Program takes a two-step approach to implementing the separation. The first step, a mere separation of accounts, will only yield transparency. It is a condition prior to first disbursement for the subsidy component. The second step, a more radical transformation of the new FOVI, will be defined during Program

execution. (See paragraph 4.20 and following.)

Special contractual clauses:

Prior to first disbursement, FOVI will have to formalize the agreements reached with the Bank during project preparation concerning policy reforms and improvements in operations. Specifically, FOVI must present evidence that:

- The appropriate fund transfer agreements between the Borrower and FOVI have entered into effect. (See paragraph 3.1.)
- FOVI's Board (*Comité Técnico*) has approved FOVI's revised credit regulations to include: (1) the new subsidy program and its detailed administration mechanism; the new subsidy policy will be (a) targeted to below-median urban income households in a transparent way; (b) progressive, up-front and portable; (c) limited to six years of minimum wage per borrower, for the lowest-income eligible beneficiaries; and (d) structured in such a way that it encourages the mobilization of household savings (see paragraphs 1.14 and 1.15); (2) the mechanism to link on-lending rates to a well-defined market-based benchmark, so that on-lending rates cover FOVI's real costs and do not distort the credit market; (3) strict criteria to select and monitor intermediaries, including minimum capitalization level and maximum delinquency rate; and (4) provisions as to the diversification of counterparty risk of FOVI with its intermediaries. FOVI agrees that any substantial change to:
 - ?? item (1) or (2) above, or any reduction of the minimum capitalization level of SOFOLES without access to the capital markets below 5.8%, or any substantial change in the methodology used to compute the capitalization level, shall require the Bank's prior consent; and
 - ?? items (3) or (4) above shall require prior consultation with the Bank. (See paragraph 3.4.)
- The Program's operating regulations have entered into effect in a form substantially equivalent to the outline agreed upon during loan negotiations. (See paragraph 3.3.)
- SHCP has approved the transfer of FIDEC resources to FOVI, for both FOVI's capitalization and the financing of its lending program. (See paragraph 3.5.) This obligation of SHCP will also be included in the guarantee contract.
- FOVI's board has determined that, in addition to its mandatory accounting records, FOVI will maintain separate records for the following accounts: (1) old portfolio; (2) new portfolio; (3) primary mortgage insurance; and (4) systemic risk insurance; as set out in paragraph 3.5.
- The Housing Research Unit (HRU) has been established and given responsibility to evaluate Program execution; and a detailed execution plan for the technical assistance component has been agreed upon with the Bank. (See paragraph 3.10.)

A mid-term evaluation will be carried out by the Bank when US\$250 million of loan resources have been committed to verify that: (1) the policy changes agreed upon during project preparation are progressing satisfactorily; and (2) solutions have been designed and are being implemented to ensure that both FOVI's up-front subsidy program and mortgage credit program have sustainable sources of funding. (See paragraph 3.6.) Specifically, before additional commitments can take place FOVI must provide evidence that:

- FOVI's Board has approved and incorporated within FOVI's revised credit regulations: (1) enhanced origination and servicing standards; (2) procedures for the environmental review of projects; and (3) gender equity policies.
- An agreed system has been implemented to monitor the impact of the new subsidy policy in the following areas: housing price and size; income distribution of beneficiaries; and level of down payment. A preliminary evaluation of the new subsidy policy has been carried out, and the subsidy policy has been adjusted to take into account the lessons learned from the evaluation.
- For the period of origination corresponding to the disbursement of the first US\$250 million of IDB resources, FOVI's credit program has been adequately financed, with FOVI mobilizing at least one peso at market rate for every IDB peso equivalent. For the future, FOVI's Board has approved a sustainable funding strategy for its credit program, and there are tangible signs that strategy implementation has started. More specifically, at least two pesos must be mobilized from market rate sources for every peso from the second half of the IDB loan.
- For the period of origination corresponding to the disbursement of the first half of IDB resources, FOVI's up-front subsidy program has been adequately financed and subsidies for at least US\$60 million will have been generated aimed at below-median urban income households. For the future, the Government has clarified the long-term strategy for the funding of the up-front subsidy program. For the second half of IDB resources, FOVI will generate at least US\$60 million in subsidies aimed at below-medium urban income households.

Other contract conditions will include the establishment of a 10% revolving fund (see paragraph 3.13) and required biannual progress meetings between the Bank, SHCP and FOVI (see paragraph 3.20).

Poverty-targeting and social sector classification:	The proposed Program does not meet the eight replenishment's poverty reduction mandate.
Exceptions to Bank policy:	None.
Procurement:	Standard Bank procurement policies, to be set out in Annex B of the loan contract, will apply for all procurement. The Program does not call for direct financing of construction works. International public bidding will be required for the acquisition of goods and related services in excess of US\$250,000. Consultant services will be procured according to the procedures to be set out in Annex C of the loan contract. International publication of announcements will be required for selection and hiring of consultants in excess of US\$200,000. (See paragraph 3.19.)

